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BANK OF AMERICA

Economic Outlook United States 1983

Overview

December 1982

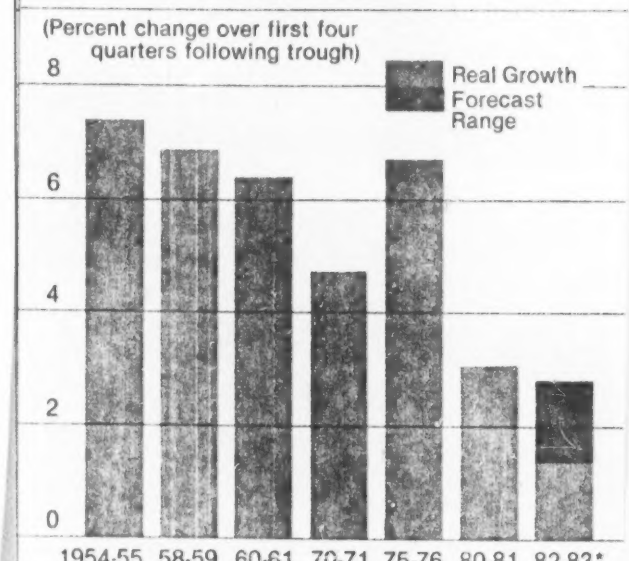
The U.S. economy struggled through most of 1982 to effect a transition from recession to recovery. The process now appears to be nearly complete, and the risks of a new downturn have faded. But doubt about the direction of the economy has been replaced by uncertainty about the strength and durability of the recovery in 1983. A number of variables could hold GNP growth to a low of approximately 1.3 percent or allow the economy to expand by about 2.5 percent. The lower level of growth would mean another year of near stagnation, with rising unemployment. The higher level would reflect a stronger economy gaining momentum as the year progresses. Still, that performance would constitute a weak recovery by historical standards. (See Figure 1.)

The wide disparity in growth projections reflects the extreme uncertainties facing the economy. First is the degree to which the U.S. and world economies have been weakened by the global recession. Real output in the United States is virtually unchanged from its level of 3½ years ago. Such a prolonged period of stagnation is unprecedented in the post World War II period. It has left a legacy of records that includes the highest rates of unemployment and business bankruptcies, the highest level of excess capacity, and the most severely deteriorated business balance sheets in the past 35 years.

The initial stimulus for recovery must come from increased consumer spending—particularly on autos and other durables—and on home purchases. Such spending will allow businesses to finish drawing down excess inventories and begin restocking, so that inventory rebuilding will also contribute to the recovery. But the remaining sectors of the economy will provide no help in the early stages of the expansion. The recovery in business fixed investment spending will be delayed and sluggish. Government spending also will be flat in real terms. With the world economy recovering only slowly from a global recession, trade will be weak, and U.S. net real exports will decline.

With reasonable growth in consumption and housing expenditures, the economy can recover even in the face of these weaknesses, providing real GNP growth in the 2.5 percent range. But any additional weakness will lead to lower growth. High unemployment and declining confidence could cause the consumer to retrench—to save rather than spend. In addition, net exports could weaken further. Excess capacity and weak balance sheets will retard investment, and a deterioration of confidence, heightened uncertainty, or another surge of interest rates could lead to further cutbacks.

FIGURE 1 AVERAGE GROWTH IN REAL GNP DURING RECOVERY PERIODS 1954-1983



*Third Quarter 1982 to Third Quarter 1983; Bank of America forecast.

To uncertainty about the consumer and investment response must be added uncertainty about policy. While the evolution of fiscal policy poses some questions, the real issue centers on monetary policy. Following two years of restraint, the Federal Reserve recently has allowed money growth to accelerate. If this easing continues, it will lend impetus to the recovery. Indeed, in that case, the recovery could be even stronger than 2.5 percent, for the economy would be snapping back from a depressed level. But if the Fed instead follows a restrictive course, it will limit economic growth. Sufficient restraint could hold growth to about 1.3 percent.

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Consumer Spending—Strength or Weakness Will Largely Determine Degree of Recovery

Since consumer spending declines only in periods of severe economic distress, it is expected to provide support to aggregate demand in 1983. During the 1973-75 recession, when real output dropped 5 percent, consumption fell less than 1 percent. During the past two years, with the economy flat, consumer spending has continued to rise, although weakly. Unless incomes decline sharply, consumption spending will grow in 1983, providing the necessary locomotive for recovery.

Nevertheless, high unemployment and interest rates, combined with consumer wariness, will lead to relatively weak growth. Consumer spending will rise about 3 percent in real terms, which is low in comparison with previous recoveries. Slowly growing total employment in 1982, sharply evidenced by a high and rising unemployment rate, retarded the rise of personal incomes. Because employment growth normally lags a cyclical recovery, the unemployment rate will decline only slowly and will still be near 9.5 percent at the end of 1983. As a result, incomes will continue to grow slowly. The tax cut of 1982 provided a needed stimulus to incomes, and the reduction scheduled for July 1983 will provide another boost. But the net effect will still be relatively slow income growth in 1983.

The consequent drag on consumer spending will be reinforced by a tendency of households to save a higher percentage of their incomes, reflecting, in part, their general uncertainty and limited confidence. This slow consumer spending growth also reflects high real interest rates, which discourage borrowing and spending. Also, the slowing of the inflation rate has removed the "buy ahead" psychology that for a while led households to spend a higher proportion of their incomes.

Thus far, consumer spending has risen only weakly following the income tax cut of July 1982. To some extent, this slow response was expected, for it takes time for spending patterns to adjust to altered income levels. Consumption should gradually strengthen in lagged response to the higher incomes. However, it is possible that decreased confidence and increased saving incentives will largely offset the stimulus of income growth, so that consumption spending will respond more weakly than anticipated. If so, the level of recovery will be lower.

During 1983, spending on durable goods will experience the greatest percentage increase. Real spending in this category has fallen for three years, largely because of declining automobile sales. The result is a large backlog of demand, which consumers will move to satisfy as incomes strengthen and lower interest rates reduce the cost of debt-financed purchases. Lower interest rates also will indirectly affect consumer spending on durable goods as increased home buying induces purchase of home furnishings.

The strengthening in total durable goods spending is heavily dependent on an expected rise in automobile sales. Auto sales have fallen 31 percent from their 1978 level as a result of weak income and high ownership costs. During 1978-81, large increases in gasoline prices, as well as in purchasing and financing costs, raised the expense of car ownership more rapidly than overall consumer prices. In 1982, the relative cost of car ownership began to fall as gasoline prices declined and as the average purchase price of cars increased at a slower rate. But the stimulative effect on demand was offset by weak incomes.

During 1983, modest increases in gasoline and car purchase prices, combined with lower installment loan interest rates, will reduce the costs of car ownership. The consequent stimulus to demand, reinforced by somewhat stronger income growth, will lead to a modest increase in auto sales. Sales will rise from 1982's 7.8 million units to between 8.4 and 8.8 million units in 1983. Such a performance, while still below the 1978 peak level of 11.2 million units, will constitute the first increase in sales in four years.

Upturn in Housing from Depressed Levels Should Add Some Impetus to Recovery

Since falling to their lowest post World War II level in late 1981, housing starts have risen, even in the face of extremely high interest rates. The increase so far has been modest—from an annualized rate

TABLE 1 SELECTED ECONOMIC INDICATORS FOR THE U.S. ECONOMY 1981-1983

	1981	1982	1983
	(Percent Change)		
Real GNP	1.9%	-1.7%	1.3-2.5%
Consumer Price Index	10.3	6.1	5.2
Nominal GNP	11.6	4.5	8.1
Personal Consumption	10.6	6.9	8.5
Consumer Durables	9.4	3.0	11.7
Plant and Equipment Investment	12.0	0.0	-0.3
Residential Structures Investment	1.7	-6.2	32.0
Exports	8.3	-2.0	3.1
Imports	8.7	-1.7	9.9
	(Volume—Millions of Units)		
New Passenger Car Sales	8.5	7.8	8.6
Total Housing Starts	1.1	1.0	1.4
	(Percent of Work Force)		
Unemployment Rate	7.6	9.6	9.9

Bank of America estimates for 1982; forecasts for 1983.

of 870,000 units in the fourth quarter of 1981 to 1,110,000 units in the third quarter of 1982. Still, for housing starts to have risen at all in view of the adverse economic circumstances indicates strong underlying demand.

The main force fueling the demand for housing is the increasing number of people in the prime home-buying age groups. The adult population will grow 1.6 to 1.7 percent annually over the next two years. More than 40 percent of this increase will occur among young adults in their 20s and 30s and among the over-65 age group. The former constitute the prime first-time home-buying group, while the latter form a pool of demand for multifamily and small single-family housing.

With underlying demographic demand strong, only improved economic conditions are required to bring about a housing recovery. Favorable forces include somewhat stronger income growth, lower interest rates, and improving household liquidity. Of these, the most important is mortgage interest rates. Their high levels were the main cause of the housing decline, and they continue to limit growth. Declining mortgage rates will allow an increase in housing starts to a 1983 level of about 1.4 million units. Should mortgage rates fail to decline in 1983, the housing recovery is not likely to materialize.

Two factors will limit a stronger housing recovery. The first is affordability. Mortgage interest rates, while declining, will still be high, as will house purchase prices. The combined cost will continue to represent an unserviceable debt for many potential buyers, limiting demand. For that reason, the housing recovery will be concentrated in the more affordable lower-priced segment of the market. In addition, the rental market will be strong as more individuals choose to rent rather than buy.

Moreover, housing has lost some of its luster as an investment. During the second half of the 1970s, the demand for housing surged as interest rates lagged behind inflation and the rate of appreciation in housing prices rose. As a result, the purchase of a house often yielded a high rate of return, and home purchase was stimulated by an investment incentive. But in the past several years, slowly rising home prices and high interest rates have reduced the rates of return on housing and largely eliminated the investment incentive from home purchases.

The housing industry illustrates the mixed results expected from the overall recovery. Growth is starting from such a stagnant base that even a strong recovery would leave major parts of the economy depressed. Even a good percentage gain will leave the building industry and the industries that depend on it—such as cement and lumber—in difficult straits. Housing starts have been falling since the second quarter of 1978, and by the end of 1983 they still will be at about 70 percent of the earlier peak level.

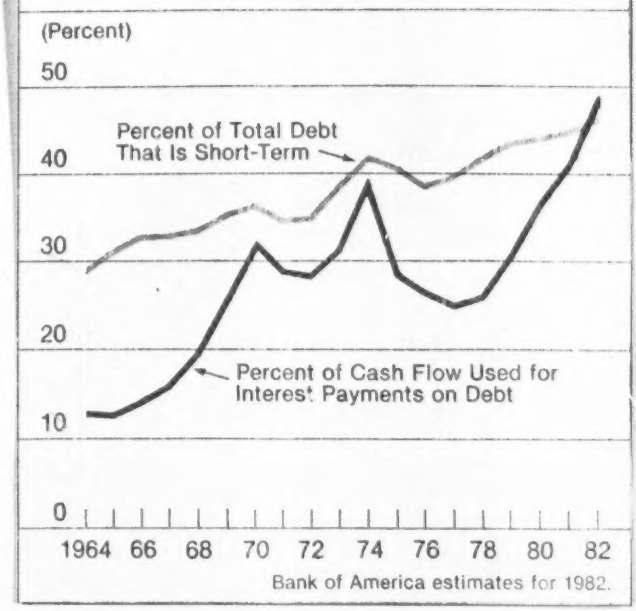
Business Fixed Investment—Still a Weak Sector

Business investment is not only one of the economy's weakest sectors, it is also an area of considerable uncertainty. The current fall-off could prove to be more severe than expected, and the weakness could spread to the rest of the economy, delaying recovery. In addition, if the subsequent expansion proves weaker than expected, the already sluggish recovery would lose a needed base of support.

Investment spending continued to rise for an unusually long time after the economy started to falter in mid-1981. Spending for equipment continued to rise through the fourth quarter of that year, while spending for new plants did not peak until the second quarter of 1982. Investment helped sustain the economy at the time, but now contributes to the currently poor investment outlook—for two reasons. First, investment helped to create the postwar record overhang of excess capacity reflected in a capacity utilization rate that is under 70 percent. Until this excess is worked off by expanding output, the need for additions to capacity will be limited.

Second, to finance new investment and involuntary inventory accumulation, businesses assumed additional debt. They did so at a time when profits and cash flow were being driven down by a declining economy and interest rates were rising. As a result, business debt service burdens rose to record levels. (See Figure 2.) By 1982, they had reached nearly

FIGURE 2 SHORT-TERM DEBT AND DEBT SERVICE BURDEN OF U.S. NONFINANCIAL CORPORATIONS 1964-1982



50 percent of cash flow. Moreover, because businesses expected interest rates to decline in the future, they relied on short-term debt.

Businesses must now cope with deteriorated balance sheets, a high proportion of short- to long-term debt, high debt-to-equity ratios, and high debt service burdens. These ratios have risen slowly as views of the appropriate financial structure have changed. But the past two years show a pronounced and more rapid deterioration. It will take time to restore health to balance sheets, and until that task is completed, investment will be delayed. To the extent that funds are used to retire and restructure debt, they will not be available for capital investment. In some cases, primarily manufacturing, balance sheet deterioration is so advanced that it imposes an absolute constraint on further investment.

Even if the economy grows at the upper limit of its anticipated range, investment spending will be weak. Total business fixed investment spending will fall in real terms through at least the first quarter of 1983. By midyear, it will begin a gradual improvement. But the retarding effects of excess capacity and financial constraints, reinforced by still-high real interest rates, will make the recovery relatively weak through 1983.

Equipment spending will pick up first, leading the overall recovery in investment. Growth in spending for structures, which continued for longer than that for equipment, will also decline for a longer period. Real expenditures will not pick up until at least the fourth quarter of 1983.

The anticipated aggregate decline in investment is not particularly harsh. The likely peak-to-trough decline is 10 percent, very close to the 9.5 percent average of previous investment cycles and considerably less than the 16 percent decline of 1973-75. The severity of the decline is expected to be alleviated by the stimulus to investment provided by liberalized depreciation allowances and the increased investment tax credit.

But with a greater excess capacity and weaker growth prospects now than in the past, this expectation could prove optimistic. Businesses must make investment decisions on the basis of expectations, including production levels and tax regulations. Added to low confidence in the strength and durability of the recovery is confusion about the direction of fiscal policy.

This lack of confidence could lead to a cutback of investment spending plans. The precipitating force could be any of the factors discussed—a shift in fiscal policy, a tightening of monetary policy, a consumer retrenchment that weakens final demands, a more severe deterioration in international trade, or a simple shift to pessimism. The result would be a more pronounced cutback in business fixed investment, with a peak-to-trough decline of 15 to 17 percent and real output growth in the 1.3 percent range.

Slow Growth Implies Diverse Industry Results

As 1983 progresses, economic growth will become more broadly based and gain strength. But during the early stages of recovery, the only sources of strength will be consumer and defense spending and a slower rate of inventory decumulation. So while part of the economy is growing, other parts will continue to experience declines or, at best, mild improvement. Even in a "normal," stronger recovery, when one or two quarters of 8-percent-plus real growth is not uncommon, some industries continue to experience problems. Indeed, business failures typically continue to increase for a quarter or more beyond the cycle trough. But in this recovery, a number of sectors will find it more difficult than usual to distinguish between recession and recovery.

The effects of this slow recovery can best be seen by contrasting it with a "normal" or average recovery. While no industry is totally immune to a business cycle, some are far more sensitive than others to cyclical swings. As a result, a downturn in overall activity appears as an accentuated decline in the cyclically sensitive industries—capital goods, housing, autos—and the industries that depend on them —cement, lumber, metals, etc. In contrast, a downswing in total ouput shows up as a much smaller decline or as simply a reduced growth rate for the cyclically stable sectors—largely services, necessities, and, traditionally, government.

The differing cyclical sensitivity of industries is illustrated in Table 2. For the "Highly Sensitive" industries listed in the first column, a change in GNP is magnified by a factor of 1.5 to 2.5. Thus, during a typical recovery when GNP is rising approximately 8 percent, these industries will experience growth rates of 12 to 20 percent. In contrast, during the first half of 1983, GNP will be growing at rates of only 2 to 3.5 percent under the stronger growth forecast. If averages hold, that would imply a rebound for highly sensitive industries of only 3 to 9 percent. If the economy grows more slowly, the rebound for these industries would be cut in half.

But for many of these industries, even an average response may be optimistic, since sectors of the economy they service are experiencing adverse structural change. Examples include the lengthening of the automobile trade-in cycle, the purchase of condominiums instead of single-family homes, and the substitution of telecommunications for business travel.

Even some of the cyclically stable industries, which normally provide a positive base for growth, are experiencing negative structural changes. Cutbacks in federal, state, and local spending constitute a longer-term trend that won't reverse itself with the recovery. Markets will be weak or declining in real terms for such diverse government-dependent industries as construction (at least 25 percent of

TABLE 2 INDUSTRY SENSITIVITY TO CHANGES IN GROSS NATIONAL PRODUCT

Highly Sensitive	Sensitive	Not Sensitive
A change of 1 percent in GNP generates a 1.5 to 2.5 percent change in industry sales.	A change of 1 percent in GNP generates a 1.0 to 1.5 percent change in industry sales.	A change of 1 percent in GNP generates a 0.1 to 0.5 percent change in industry sales.
Transportation Equipment	Paper & Printing	Agriculture & Food Processing
Primary & Fabricated Metals	Textiles & Apparel	Mining
Machinery	Instruments	Utilities
Chemicals	Transportation Services	Business, Educational & Health Services
Construction	Lumber	Finance, Insurance & Real Estate
Furniture	Petroleum	
	Wholesale & Retail Trade	

which is publicly financed), business services, office equipment, and paper.

The reversal of the 1970s trend toward a declining defense share of GNP is one of the few sources of strength for industry in 1983. Federal government outlays for defense are projected to grow approximately 8 percent per year in real terms during the next five years. Although it is likely that some cuts in the defense budget will be made to reduce the size of the deficit, these cuts will have little impact on the more than $215 billion to be spent in 1983 and will, instead, affect funding for programs in 1985 and beyond. Concerns that such massive expenditures will overtax the capacity of defense suppliers, leading to bottlenecks and sharp increases in production costs, have been allayed for 1983 by the present low levels of capacity utilization of all major suppliers.

Government Spending—No Support to the Recovery

Total government spending in 1983 will be flat in real terms as modest growth in federal government expenditures is offset by declines in state and local spending. The Reagan Administration has succeeded in reducing the growth of federal government expenditures, which was one of its primary goals.

Purchases of goods and services, which measure the direct influence of the federal government on aggregate demand, will rise 3 percent in real terms. But total real federal expenditures will rise only 2.5 percent in 1983, down from an average growth of 3.7 percent over the period of 1971-1980. The 1983 increase conceals a great deal of change in the components of spending. While defense spending will rise about 6 percent in real terms, nondefense spending will fall more than 3 percent in real terms. The biggest cuts have come in federal grants-in-aid to state and local governments. These will fall nearly 12 percent in real terms in 1983.

The cutbacks come on top of revenue losses from the recession, as weak incomes have reduced the growth of tax revenues. Because most state and local governments are required to operate with balanced budgets, the revenue losses will force them either to cut spending or to raise taxes. With voter resistance limiting the latter option, state and local governments will be forced to pare government spending even further. In real terms, state and local spending will drop about 1 percent in 1983, marking the third straight year of decline.

Foreign Trade—Little Improvement Expected

Foreign trade was adversely affected in 1982 as the worldwide recession cut demand and reduced trade flows. A number of factors provide little prospect for significant improvement in 1983. First, demand will remain relatively weak as most world economies will recover only modestly or simply stagnate. Second, trade barriers are rising. In part, this is a reaction to high unemployment, which is at post World War II record levels in Europe and the United States. Rising trade barriers also reflect the fact that many countries have incurred large debt burdens, which they are attempting to reduce by limiting imports and increasing exports. When such efforts become widespread, they simply reduce total trade, for one nation's imports are another's exports.

Growth prospects of countries that are heavily dependent on trade are poor as a result of weak world trade. Countries that are counting on vigorous export growth to provide the base for domestic recovery will be disappointed. The United States also will be affected, but to a lesser degree, since trade represents a smaller proportion of output here than in most other nations. The combination of the dollar's high international value, weak foreign economic growth, and rising protectionism elsewhere will lead to a decline in real net exports.

The trade-weighted value of the dollar fell through most of the 1970s, and by late 1980 had declined to 70 percent of its 1969 value. But during the two-year period from the third quarter of 1980 to the third quarter of 1982, the dollar's value rose 42 percent,

totally offsetting a decade's decline. The rise reflected a combination of factors: declining inflation, slow economic growth, and high interest rates. Those factors, together with the perception of the United States as a stable political and economic entity in an increasingly risky world, are responsible for the flight of international capital to the dollar.

The appreciation of the dollar raised the price of U.S. export goods and lowered the price of imported goods, thereby tending to retard exports and increase imports. Because it takes time for adjustments in export and import levels to appear, the effects of the past dollar appreciation have just begun to appear and will lead to a further deterioration in the U.S. trade balance in 1983.

At the same time, even a weak U.S. recovery will increase imports, as higher incomes stimulate demand for all goods. Declining oil imports were a special factor in helping to reduce total 1982 imports. But demand will begin to rise in 1983 as oil prices stabilize and import balances rise.

The net effect will be a modest growth in exports more than offset by rising imports. The U.S. merchandise trade deficit will rise to about $55 to $60 billion, and the nation's current account will swing from a near balance in 1982 to a deficit of approximately $15 to $20 billion in 1983.

Inflation—Single-Digit Rates Continue

In considering the variety of problems facing the economy, it is easy to lose sight of what may be the Reagan Administration's most important accomplishment—its role in the large and rapid reduction in inflation. The rate of increase in the Consumer Price Index fell from 13.4 percent in 1980 to approximately 6 percent in 1982. Even measured by the broader based GNP price deflator, inflation has fallen by a third, from 9.3 percent in 1980 to about 6 percent in 1982. The GNP price deflator is expected to rise 5 to 5.5 percent in 1983.

The fundamental cause of declining inflation has been the slack markets accompanying monetary restraint. The first step in reducing inflation was to change expectations. In 1980, the Federal Reserve began to reduce the rate of monetary growth. But relatively few people believed that monetary restraint would last long enough to change the trend path of inflation. The Federal Reserve had begun anti-inflation efforts before, but whenever the economy slowed, political pressures forced an easing of monetary restraints—and a prolonged period of stimulus and rising inflation followed.

The expectation that the Federal Reserve's anti-inflation effort would be short-lived led to stubborn expectations of high inflation. Many business people and investors viewed the decline in actual inflation in 1981 and early 1982 as merely a cyclical phenomenon and continued to perceive the trend inflation rate as in the 9 to 10 percent range. But by mid-1982, most people gradually came to perceive the improvement as fundamental and enduring.

Achieving that change in expectations was the first and most difficult part of the disinflation process, for expectations of inflation substantially affect actual inflation. For example, labor and other contracts are negotiated with at least an implicit expectation of inflation, and high inflation expectations lead to high wage and price settlements.

Declining inflation expectations increase the speed with which price declines in one sector are transmitted to other sectors. More important, the downward revision of inflation expectations builds its own momentum. That means the Federal Reserve can deviate from its policy of strict control of money growth, at least for short periods, without immediately engendering fears of resurgent inflation.

Monetary growth is the ultimate determinant of inflation, but the lag between a change in monetary growth and the resulting change in inflation is often long and variable. With inflation expectations revised downward, and with labor and capital markets characterized by so much slack, the Federal Reserve could raise money growth significantly over the near term with little effect on inflation in 1983. This conclusion is supported by examining unit costs, which are the immediate determinant of prices.

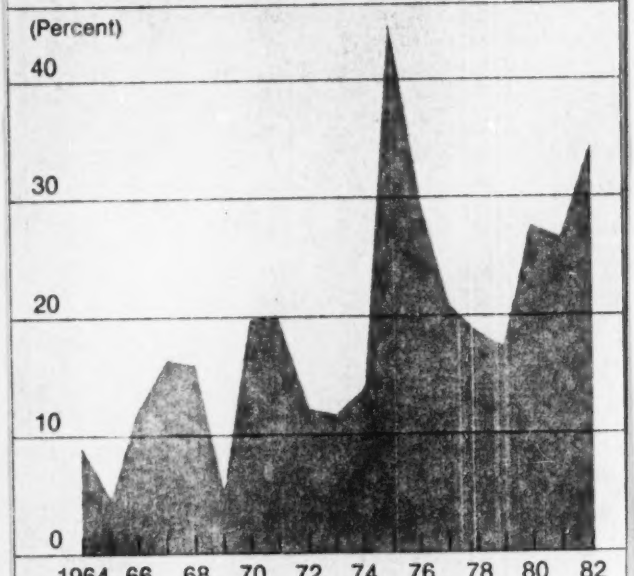
Unit labor costs account for 65 percent of total costs. The growth of wages will continue to moderate as a result of the high unemployment rate, which will still be near 9.5 percent by year-end 1983, and declines in both the inflation rate and inflationary expectations. The rate of increase in average hourly wages will decline from about 7 percent in 1982 to about 6 to 6.5 percent in 1983.

Productivity has already begun to improve as businesses have cut employment and otherwise moved to increase the efficiency of their operations. Once output begins to expand, productivity will improve even more, averaging 2 percent for 1983. That will slow the growth of unit labor costs to a range of 4 to 4.5 percent. Unit capital costs and expanding profit margins will lead to a somewhat higher rate of price increase.

Interest Rates—Some Upward Movement, Then A Resumption of Downward Trend

Large federal deficits will tend to raise interest rates in 1983, but declining inflation expectations and relatively weak private credit demands will produce an offsetting downward pressure. Normally, an economic recovery tends to shrink the federal deficit, as the progressive federal income tax causes tax revenues to grow more rapidly than expenditures. But the tax changes instituted during the past two years, together with the tax reduction scheduled for 1983, will largely offset the progressivity of the tax structure. Consequently, federal credit demands will

FIGURE 3 U.S. GOVERNMENT BORROWING AS A PERCENT OF TOTAL BORROWINGS 1964-1982



Bank of America estimate for 1982.

remain large, in both absolute terms and as a percentage of the supply of loanable funds. (See Figure 3.)

Several factors are expected to offset the consequent upward pressure on interest rates. First, business credit demands will be weak. During 1981 and 1982, private credit demands were unusually high, primarily because of increased business borrowing, which was held up in the early stages of the recession by the prolonged capital spending boom and, subsequently, by the need to finance inventory accumulation. Both demands for funds coincided with declining profits, and so forced increased reliance on external finance.

As the economy recovers, business profits and cash flow will increase. Coupled with slow growth in fixed investment and cautious inventory rebuilding, business credit needs will decrease through much of 1983. Other private credit demands will grow, but the net effect will be weak growth in total private credit demands.

Moreover, the personal savings rate is expected to remain relatively high, so that as incomes grow, the total supply of loanable funds will rise. This reflects not only uncertainty and cautious spending attitudes, but also greater savings incentives from high interest rates, reduced marginal income tax rates, and lower inflation. These have combined to raise the real after-tax return on savings and the real costs of borrowing. Consequently, individuals have an incentive to save more and borrow less.

The net result is likely to be slower growth in the demand for credit than in the supply of credit, allowing at least a moderate downward trend in rates. Finally, the continued downtrend in actual and expected inflation will decrease pressure on rates by reducing the inflation premium. The effect will be particularly pronounced for long-term rates, which are more dependent than short-term rates on long-term inflation expectations.

The Federal Reserve recently has allowed growth in M-1 to surge, partly to give impetus to the recovery and partly because money growth is being distorted by temporary technical factors, including maturing All-Savers Certificates and the introduction of a new deposit account at banks and thrift institutions that is competitive with money market funds. The Federal Reserve will have to re-establish control over money growth, which will probably occur in early 1983—a move that will be accompanied by rising rates. But the rise will be temporary, and rates will subsequently trend downward.

The size of the decline in rates will depend on the strength of the overall recovery, for this will determine the growth of private credit demands and inflation. If the economy grows near the upper end of its anticipated range, interest rates will rise temporarily in the first half of the year and then resume a downward trend. The prime rate, for example, will end the year in the 10 to 12 percent range. If the economy is weaker, with real GNP growing near the 1.3 percent lower limit of its anticipated range, private credit demands will be lower. As a result, interest rates could decline more, so that the prime rate could end the year in the 8 to 9 percent range.

Policy—Time for Adjustments

Fiscal and monetary policies underwent a wrenching shift of direction in the past two years. Reductions in the growth rates of government spending and the money supply marked the beginning of a reversal of a 20-year trend of rising spending and accelerated money growth. These changes have achieved a major success—a large reduction in inflation in a short time. However, they also contribute to past and projected weakness in the economy.

The task for policymakers in 1983 and beyond will be to encourage the recovery while not risking gains already made against inflation. Since the options for significant change in fiscal policy in 1983 are limited, the primary responsibility for guiding the economy will fall on monetary policy.

A change in fiscal policy will be undertaken with a primary focus on 1984, since federal spending for 1983 is largely fixed. Spending decisions made in 1983 will take effect in fiscal 1984. Tax changes can be implemented any time, but early action is unlikely, because of time required for Congress to deliberate and enact legislation.

Debate will focus on how to reduce the large deficits looming for the next several years. Changes will

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probably include a scaling down of the defense buildup, more rapid growth than currently intended in other government spending, and some additional rollbacks of previously scheduled tax cuts. This conclusion is easily reached by process of elimination, for there is little choice if the deficit is to be reduced. National defense expenditures, together with so-called "uncontrollable" expenditures—such as interest on the public debt plus entitlements programs (Social Security, veterans' benefits, and the like)—averaged 83 percent of federal outlays during the 1970s. By the third quarter of 1982, this proportion had risen to 87 percent. The rest of federal spending has correspondingly shrunk from 17 percent of the total in the 1970s to 13 percent by late 1982. It is in this category that actual spending cuts have been made. Other categories, together with total spending, have continued to grow.

However, there is a limit to how far the controllable category can be cut. Reductions already made have been difficult politically. Future reductions will be progressively more difficult because they will cut closer to the core of each affected program. When the limit is reached, the American people will have to face the fact that continued rapid growth in defense and entitlements programs requires higher —not lower—taxes. Choices will have to be made about the desired weight of the tax burden and the composition of the budget. During 1983, a serious discussion of the issues will at least start.

In one sense, the emphasis on the deficit itself is misplaced. The real problem is the level of government spending, which takes resources from the private sector. Whether that spending is financed directly by taxes or indirectly by debt-financed deficits determines whether the burden of government is borne by taxpayers or by potential borrowers, for whom fewer funds are available when the government borrows.

Deficits do not necessarily cause interest rates to rise, but do make them higher than they otherwise would be by increasing the competition for limited funds. This retards such interest-sensitive spending as business investment and residential construction. This "crowding out" of private interest-sensitive spending threatens a vigorous recovery and long-term productivity growth. This is the real basis for concern with deficits.

Monetary authorities will have a difficult course to pursue in 1983. The Federal Reserve reduced money growth to lower inflation, expecting this policy also to put a brake on the economy. But it is doubtful that the Fed expected the economy to weaken as much as it did; and it is certain the Fed does not want it to weaken any more. It remains committed to a long-run goal of reducing inflation. But the Fed's near-term priority has shifted to stemming the economy's decline and fostering the recovery.

It may be time in 1983 for some policy adjustments. Reducing the deficit through broadly based reductions in spending and even some rollback of tax cuts would allow interest rates to decline and thus stimulate investment and long-run productivity growth. Monetary policy could strengthen the recovery without rekindling inflation by allowing strong monetary growth over the near term. Once a vigorous recovery is established, monetary policy could again aim at a gradual, long-run reduction in monetary growth.

Such adjustments might be criticized as a retreat from the original goals of the Reagan Administration. The criticism might be valid, but a partial retreat is not surrender, and these adjustments would allow the Administration to retain the overall thrust of its original policies.

The danger this Administration has always faced is that its program would generate a political backlash strong enough to force abandonment of its policies. Political opposition is mounting, and the most prudent course may be one of accommodation. Failing that, there might be a return to old policies of surges in the growth rates of government spending and rapid money growth. That would be unfortunate, for the economy has gone through a period of adjustment to new policies, an adjustment that has entailed high cost in terms of lost output and idled resources. Some sectors will continue to pay that cost for some time. But in the aggregate, the worst of the adjustment is over, and regardless of whether the recovery in 1983 is strong or weak, it will be followed by healthier growth in the years beyond. A policy reversal now would mean that the costs the economy has borne would have been for naught.

Bank of America NT&SA, founded in 1904 by A. P. Giannini, has nearly 1,100 branches in California communities and 135 branches and representative offices overseas. As of September 30, 1982, BankAmerica Corporation's consolidated assets were more than $120 billion.

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